Committee Name:

Infrastructure Responsibilities and Funding Subcommittee

Members:

John Atkins, III (Chair)
Dan Gerlach (Co-chair Oversight)
Rep. Linda Coleman
Mayor Allen Joines
Mike Ruffin
Gwynn Swinson

Meetings:

December 19, 2006 (11:30a.m. – 12:30p.m.)
January 22, 2007 (9:30a.m. – 12:30p.m.)
February 12, 2007 (9:30a.m. – 11:00a.m.)
February 19, 2007 (10:00a.m. – 11:00a.m.)
February 26, 2007 (9:30a.m. – 11:15a.m.)
March 2, 2007 (9:30a.m. -

I. Brief review of the subcommittee's charge

The subcommittee's charge is to examine the infrastructure needs of the State and local governments, including, but not limited to water and sewer, roads and other transportation needs, schools, and courts and determine: (1) whether the division of responsibilities between the State and local governments is appropriate; (2) whether any changes are needed to align responsibilities for infrastructure in accordance with the general principles of efficiency, appropriate control, transparency, and equity; and (3) determine the fiscal impact of any suggested changes on the State and local governments.

II. Issues dealt with over the last two months

The subcommittee, in order to manage its workload, focused mainly on public school construction, transportation infrastructure and water, sewer and stormwater infrastructure as the three most important state-local areas of fiscal responsibility.

III. Speakers providing information to the subcommittee, a summary of the presentations and a global summary of the subcommittee's research to date

Presentation Summaries

School Construction Financing

Dr. Ben Matthews, Director, School Support Division, NC Department of Public Instruction

- Dr. Matthews reviewed the 2005-2006 North Carolina Public Schools' Facilities Needs Survey. (The survey must be performed every five years, pursuant to N.C. Gen. Stat. § 115C-521(a), requiring "Local boards of education [to] submit their long-range plans for meeting school facility needs to the State Board of Education . . . every five years . . . . In developing these plans, local boards of education shall consider the costs and feasibility of renovating old school buildings instead of replacing them.") According to the survey results, local school boards' projected needs over the next five years for new schools, furnishings and equipment, land acquisition, and additions and renovations to existing elementary, middle, high school and other facilities totals approximately $9.8 billion. One-third of this amount reflects needs in the largest six counties. The projected needs represent an increase of 150% over the last survey (2000-01), mainly due to construction cost inflation and population increases. In today's dollars, the cost of new construction averages about $23,278 per student. Dr. Matthews also reviewed various revenue sources available to local governments for school construction projects, including various debt options, public-private partnerships, sales tax earmarks, and federal aid programs.

Rebecca Troutman, Director of Research and Public Technology, NC Association of County Commissioners

- Ms. Troutman provided subcommittee members with a written comparison and brief explanation of required school capital funding set-asides for 2005-06 (including Article 40 and Article 42 local sales and use taxes earmarks, ADM fund allocation), projected lottery proceeds for 2006-07, and five year capital needs for each county (from the 2005-06 survey). The total required capital funding set aside for all counties for 2005-06 was approximately $404 million and the projected lottery proceeds for 2006-07 is $140 million.

Kennon Briggs, Vice President, Division of Business and Finance, NC Community College System

- Mr. Briggs described the financing relationship between community colleges, counties and the State—whereby counties are required to match state funding dollar for dollar, but counties can receive credits for dollars spent on community

colleges independent of State funding. He then detailed the projected budget requirements for 2007-09 for equipment, facilities and master facilities and advanced planning for the State Community College System. The requested funds total approximately $1.4 billion. The community colleges expect that counties will match the State funds provided for renovation and repair and new construction—approximately $1.2 billion. Mr. Briggs also discussed a current study by community colleges of what facilities and programs are needed to satisfy the new economic development needs of the State.

Water, Sewer & Stormwater Infrastructure Financing

Bill Holman, Visiting Senior Fellow, Nicholas Institute for Environmental Policy Solutions, Duke University

- Mr. Holman provided a brief overview of the NC State Water Infrastructure Commission and reviewed its recent recommendations to the Governor and members of the General Assembly on potential solutions to meet the State's water infrastructure funding needs. He cited a 2005 study of the State's infrastructure capital needs by the NC Rural Center, which estimated that approximately $16.6 billion is needed between 2005 and 2030 for water, sewer and stormwater infrastructure—to develop new treatment facilities and upgrade existing facilities, to improve operations and maintenance capacities, to provide needed technical assistance and training for owners and managers, and to adequately plan for sustainable water resources. $6.85 billion is needed in the first five years. He suggested that water systems across the state are struggling because of escalating construction cost overruns pushed by global forces such as increases in petroleum and material prices that affect the cost of water and wastewater pipe. Moreover, according to Mr. Holman, federal funding for infrastructure continues to decrease, leaving many North Carolina communities without the funding needed to make system improvements or extensions. For example, there are over 100 wastewater systems under some type of order from the State, either limiting or preventing additional connections to their systems because they fail to meet regulatory standards. Among the recommendations of the Water Infrastructure Commission are that the State: (1) establish new, stable funding for water, wastewater and stormwater infrastructure of at least $100 million per year; (2) authorize a referendum for the passage of a $1 billion Clean Water Bond to replace the (now depleted) 1998 Clean Water Bond proceeds; (3) provide $50 million in State appropriation to address immediate and critical water infrastructure needs this year; (4) establish conditions on State funding that ensure financial, technical and managerial efficiency of operations; (5) provide funding for regular updates to the State water and wastewater data layers; and (6) fund phase II of the State stream mapping project.

Jean Klein, Klein Consulting

- Ms. Klein presented data on the state of water and wastewater systems in North Carolina. She noted that the majority of systems are small and that the costs to operate these systems are high compared to those of larger systems. Ms. Klein further indicated that there are over 19,000 households across North Carolina currently without water and sewer services—most located in poorer, rural areas where extension of existing water infrastructures is not economically feasible for the local governments. Ms. Klein suggested that the State needs to set policies and funding directives to encourage continued regionalization of water infrastructure.

Jeff Hughes, Director, NC Environmental Finance Center, UNC-Chapel Hill School of Government

- Mr. Hughes discussed a 2005 water and sewer rate survey conducted by the NC Environmental Finance Center and NC League of Municipalities. The survey sampled approximately 333 water and sewer utilities across the State and found that there is significant variation in the rates and rate structures and also variation in operating ratios. According to the survey results, small town systems and systems serving unincorporated areas tend to charge significantly higher rates than larger municipal systems. Despite the higher rates, the small systems often do not collect enough to cover their current operating costs, let alone the costs of capital improvements or expansions. Newer systems also tend to have higher rates than established systems because they often serve lower density rural areas and the federal government no longer makes the significant investments in systems that it made in the 1970s and 1980s. Further, the increased environmental sensitivity and subsequent regulation in some watersheds has influenced rates in those regions. With respect to regionalization, Mr. Hughes stated that North Carolina has relatively few independent regional entities—most regional utilities are actually county systems or city systems with inter-local agreements. Many potential regionalization plans have public and financial advantages at the aggregate level but never advance for political reasons and because average aggregate costs usually do not drive local decisions. Mr. Hughes commented that State investments in water infrastructure have been on par or greater in North Carolina than other southeastern states in the recent past, but these investments have been made in a feast-or-famine manner. The swings in State funding assistance have had some negative impacts on how projects are planned and built. Accordingly, Mr. Hughes believes that future best practices at the State level include longer term financing, leveraging, facilitating co-funding packages, and careful analysis of rates in determining grant allocations. At the local level, he suggests that the most important practices include realistic capital improvement plans, cash flow planning, leak detection, planned and periodic rate increases, and use of capital reserve funds. Finally, Mr. Hughes briefly talked about stormwater infrastructure financing. He noted that as local governments' responsibilities for stormwater management have increased over the past several

years, local governments are beginning to assess user fees to cover the costs. A significant amount of the revenue raised from the user fees is being used to cover the costs of existing services; thus, increases in available funds for capital purposes have been relatively modest. There also currently are limited sources of State and federal funding for stormwater capital projects.

Transportation Infrastructure Financing

Mark Foster, Chief Financial Officer, N.C. Department of Transportation

- Mr. Foster provided some general background information on North Carolina's transportation infrastructure and infrastructure financing, including the division of responsibilities for roads between the State and local governments and the breakdown of funding sources and funding uses at the State and local levels. Mr. Foster also provided comparative transportation infrastructure and revenue data for the five other southeastern states and noted that, with the exception of South Carolina, North Carolina consumers pay the least amount of combined annual taxes and fees to fund transportation infrastructure. He provided information on projected growth in North Carolina over the next twenty-five years and its impact on transportation infrastructure funding needs—detailing an estimated $65 billion funding gap for State infrastructure needs by 2030. Mr. Foster attributed the projected funding gap to construction cost escalation, delays in the completion of projects due to cash shortages, decreasing federal aid, and dramatic population increases. He also cited the failure of traditional revenue sources to keep pace—particularly the gas tax, which has not kept up with CPI and construction inflation, and the revenue from which also has decreased because of the increased fuel efficiency of vehicles. Finally, Mr. Foster stated that transportation infrastructure in North Carolina requires immediate attention to address local, state and global economic needs. At a minimum, he suggested that funding needs to keep pace with the State's growth and construction inflation. He proposed exploring new funding options and leveraging incremental new funding to accelerate project delivery.

Beau Mills, Director of Intergovernmental Relations for the NC Metropolitan Coalition, North Carolina League of Municipalities

- Mr. Mills presented information on the transportation funding difficulties faced by municipalities. According to Mr. Mills, the municipal road system in North Carolina is over 20,000 miles and is growing eleven times faster than the state road system. Transportation costs comprise a large portion of most municipal budgets. In fiscal year 2004-05, total municipal expenditures on transportation exceeded $927 million, averaging more than 11 percent of total expenditures. The costs are highest in large cities; however, the costs absorb a larger percentage of the budget for smaller municipalities. Mr. Mills indicated that transportation costs continue to rise. Municipal spending on transportation in fiscal year 2004-05 represented a 23 percent increase over fiscal year 2002-03 expenditures. The

increase is the result of both increases in the price of gasoline and asphalt and also the growth in municipal road mileage. According to data cited by Mr. Mills, the State provides over $100 million each year to 502 municipalities for transportation infrastructure (Powell Bill funds). The growth in Powell Bill funds has not kept pace with the growth in transportation costs, however. The funding has increased 3.4 percent over the past three years. And, available Powell Bill funding only covers a portion of transportation costs, especially in large cities. The funds cover about 12 percent of the largest cities' transportation costs and about 27 percent of other cities' costs. Mr. Mills suggested that some potential solutions include: (1) improving the road construction project approval process by further streamlining the permitting process; (2) continuing to look to innovative financing mechanisms, such as allowing cities to "loan" the money to the NC Department of Transportation to get projects done earlier, use of Garvee bonds, implementation of toll roads, and assessment of VMT tax; (3) considering public-private partnerships for roads; and (4) providing local governments with a greater menu of local funding options. A few municipal transportation directors accompanied Mr. Mills and briefly addressed the subcommittee. They echoed Mr. Mills' remarks that State funds are not keeping pace with local needs for transportation infrastructure funding. They also indicated that the State should look towards more regional solutions to planning and funding transportation projects.

The subcommittee also received reports on transportation funding and best practices from the NGA Center for Best Practices and the North Carolina Aggregates Association.

Debt Capacity

Vance Holloman, Deputy Treasurer, NC Department of State Treasurer

- Mr. Holloman reviewed debt options available to local governments and the Local Government Commission's process of evaluating debt capacity. As of June 30, 2006, North Carolina counties had approximately $9.5 billion debt outstanding, approximately two-thirds of which is related to school construction. North Carolina cities had approximately $7.7 billion debt outstanding, over 50 percent of which is related to water and sewer or transportation infrastructure. The average county direct tax-supported debt per capita is $1,163, with a high of $4,291 (Dare County) and a low of $29. The average city direct tax-supported debt per capita is $642, with a high of $23,077 (Indian Beach) and a low of $0. Evaluating debt as a percentage of assessed valuation, the county average is 1.405 percent, with a high of 3 percent (Johnston County) and a low of .042 percent. The city average is .741 percent, with a high of 2.293 percent (Cary) and a low of .004 percent. Mr. Holloman also reviewed the State debt capacity model for determining additional debt capacity each year.

State Facilities' Needs

- Dan Gerlach provided the subcommittee members with a written summary of the State's six-year capital improvements needs schedule. The total repair and renovations requests for education, general government, health and human services, justice and public safety and natural and economic resources for the six year period from 2007-2013 is approximately $1.3 billion. The total capital improvement requests is approximately $8.8 billion, and the total new construction requests is approximately $7.5 billion.

Global Summaries

- While tradition has it that the State is responsible for the vast majority of the road systems and the local governments are responsible for capital spending for public schools, community colleges, and water & sewer infrastructure, there has been considerable ***blending of the state-local relationship*** in these areas.

- Infrastructure costs have been skyrocketing due to the increased demands of a growing populace and ***global cost increases in building materials***. There is no way to avoid these realities.

- Raw numbers of need that appear to be unattainable should not stop the Commission from addressing the needs.

- State and local governments have the option of taking on more debt to finance needed improvements. However, there are ***limits to the amount of debt*** that can be reasonably assumed. The Governor's proposed debt package includes $250 million in support for water & sewer, but no proposal for public school construction due to the debt affordability constraints. State debt capacity for highway funds is $375 million.

- ***Public School Construction***

    - The current estimated need from DPI is $9.8 billion over the next five years.
    - Public schools are the largest component of county debt outstanding, with over $6.3 billion outstanding on June 30, 2006. Schools comprise 66 percent of the total county debt.
    - The state has shared the sales tax base with local governments, including specific requirements that certain percentages be used for public school capital.
    - The state also provides a share of the corporate income tax and the education lottery for school construction projects.

- ***Water, Sewer, Stormwater Infrastructure***

    - The current estimated need is $6.85 billion over the next five years.
    - Water and sewer is the largest component of municipal debt outstanding, with $3.5 billion outstanding on June 30, 2006. Water and sewer comprise 46 percent of municipal debt. Water and sewer is the second largest component of county debt, with almost $500 million outstanding on June 30, 2006.
    - Most of this debt and operational costs for water and sewer are funded through user fees.
    - The state has provided more money than many other states for water and sewer in the past few years, but the 1998 bond money is almost all depleted.
    - The Governor recommends $250 million in state bonds for water and sewer.

- ***Transportation Infrastructure***

    - DOT has estimated the need gap at $64 billion over 25 years, more than double the current state revenues for transportation.
    - State revenues for transportation are fairly flat this year.
    - Municipalities have $785 million in street and highway debt outstanding.
    - The State spends $1.9 billion on construction and $876 million on maintenance.
    - The State gas tax is the highest in the region, though overall consumer taxes are lower due to no local sales tax dedication and lower than average sales tax on cars.
    - Locals receive a share of the gas tax in Powell Bill aid (about $150 million).

IV. Specific recommendations (with a discussion of the reasoning and explanation for those recommendations)

The subcommittee has both global recommendations based on the general principles outlined in the subcommittee's charge and specific recommendations in the three areas of focus to date.

Recommendations Based on General Principles

Efficiency and Prioritization

Determining the best practices to keep costs down requires discipline. The Subcommittee recommends that the General Assembly and relevant agencies consider the following:

- DPI and the General Assembly should provide guidance and incentives for local school districts that furnish cost-efficient space, both for capital construction and for operating costs.
- DPI should encourage the use of public-private partnerships as options for local school districts to complete construction more quickly and efficiently.
- DENR and relevant parties should adopt the Water 2030 recommendation to promote better operation and management of water and sewer systems. Incentives should also be provided to encourage regionalization, planning, and eco-friendly practices.
- State resources for water and sewer need to be focused on those communities that have the most significant economic or environmental challenges first.
- DOT should engage professional advice on how to reduce the time to construct new roads and ensure that there are accountability measures for time to completion and quality of work.
- DOT and DENR should identify ways to complete projects more quickly and allow contractors to get permits in as timely a manner as possible.
- DOT should take advantage of permitting flexibility and financing assistance from the federal government.
- DOT priorities should be for uses of money that serve statewide tier or regional needs in order to reduce congestion and increase mobility.
- DOT should set clear performance standards and a plan to meet them.

Appropriate Control

Local Flexibility

The Subcommittee concurs with the conclusion of the Local Government Financing Subcommittee that all local governments need alternatives to the property tax and existing sales taxes to support local infrastructure, at local option. To that end, the subcommittee recommends the following:

- Local government revenue authority has a distinct component for infrastructure financing.
- Authority should be broad enough for local governments – including counties and municipalities – to have discretion over the allocation of that authority.
- There should be some connection between the revenue authority and the demand for public infrastructure; that is, growth financing the expanded infrastructure.

Debt

Bonds are not free. North Carolina and its local governments are the best-managed in the United States. A conservative use of debt and respect for debt affordability is a key component of that recognition and tradition. To that end, the subcommittee recommends:

- That the state's debt affordability guidelines be followed.
- That the Treasurer provides information on relative debt capacity for local

governments.

Equity

Benefits Received

Some public infrastructure can be financed by those who benefit most directly from the capital investment. The subcommittee recommends that the Committee consider the following:

- DENR and other organizations should provide training on water and sewer rate setting and rate structures to provide sound operation, maintenance and accountability for availability of water.
- Where appropriate, tolls and public-private partnerships may be used to finance transportation projects and increase the speed of completion.
- Proxies for use of roads and highways should remain the prevailing source of revenues for these purposes (*e.g.* gas tax, highway use tax).

State-Local Partnerships

As noted above, the subcommittee acknowledges that the state and local division of labor over infrastructure has been blurred substantially. The state has $265 million in debt service for items that were exclusively local in nature. Cities testified that they were spending money on state-owned roads, and some counties have an interest in maintaining/constructing highways. To that end, the subcommittee recommends the following:

- Any shift from local governments to state government for funding responsibility must include a swap of revenue authority or changes in budget trends to increase capacity to handle that shift.
- Any shift from state government to local governments for funding responsibility must include a transfer of revenue authority or changes in budget trends to increase capacity to handle that shift.

Specific Recommendations

The subcommittee makes the following recommendations with respect to the three areas of focus to date:

Public School Construction

- The State should continue to provide a share of the corporate income tax and education lottery for school construction projects.
- Counties, especially growing counties, should be given the option to fund school construction from growth.

Water, Sewer and Stormwater Infrastructure

- The State should issue bonds to replace the now depleted 1998 Clean Water Bonds. (The Governor's recommendation is for $250 million.)
    - The State bonds should be allocated to local utilities that have the greatest needs first (*e.g.* utilities that are under moratorium or other special order).
    - The State should also use bond proceed revenue to provide incentives to local utilities to regionalize or otherwise provide more cost effective services.
- Local governments should assess user rates to cover fully both capital and operational costs.

Transportation Infrastructure

- In the short-term, the State should consider increasing the sales tax on vehicles and weight-based registration fees.
- Over the long-term, the State should consider phasing out the gas tax and providing alternative proxies to road use such as a vehicle mileage tax.

V. Issues yet to be reviewed by the subcommittee including a plan for addressing those issues

The Subcommittee notes that there is incredible demand for infrastructure in our rapidly growing state. The subcommittee intends to research the current state-local distribution of responsibilities for, and projected future needs of, the State's Community College System, court facilities and technology infrastructure. The Subcommittee's future work must also rely on interactions with other subcommittees on their work on revenue generation and program responsibilities.

VI. Other matters that you would like to bring before the full commission.